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Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: **Policy on Payment System Risk (Docket No. OP-1478); Regulation HH – Financial Market Utilities (Docket No. R-1477 and RIN No. AD–7100 AE–09)**

Ladies and Gentlemen:

The Depository Trust & Clearing Corporation ("DTCC") appreciates the opportunity to comment on (i) the Board of Governors of the Federal Reserve System's ("FRB") proposed revisions to part I of its *Federal Reserve Policy on Payment System Risk* ("PSR Policy", and the release, the "PSR Policy Release") and (ii) the FRB's Notice of Proposed Rulemaking to provide a common set of risk-management standards in the FRB's Regulation HH, 12 C.F.R. Part 234 ("Regulation HH"), for financial market utilities ("FMUs") that are designated as systemically important by the Financial Stability Oversight Council and for which the FRB is the Supervisory Agency ("Regulation HH Release").[1]

Both the proposed revisions to the PSR Policy and the risk-management standards in Regulation HH are based on the *Principles for Financial Market Infrastructures* ("PFMI"), which were developed by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions ("CPSS/IOSCO") and published in April 2012.

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[1] The Supervisory Agency for an FMU is the federal agency that has primary jurisdiction over a designated FMU under federal banking, securities, or commodity futures laws. While the Supervisory Agency for each of DTCC's designated FMU subsidiaries, The Depository Trust Company, National Securities Clearing Corporation and Fixed Income Clearing Corporation, is the Securities and Exchange Commission ("SEC") and, accordingly, the risk-management standards being proposed in Regulation HH will not be directly applicable to them, the FRB positions taken in the proposed amendments to Regulation HH may well be indicative as to how the FRB will interpret the PSR Policy to the FMIs to which the PSR Policy applies.

Under the proposed revisions to the PSR Policy, FMIs that are subject to the FRB's supervisory authority under the Federal Reserve Act would be "expected" to meet or exceed the risk-management standards in the Appendix to the PSR Policy, and all other central securities depositories, central counterparties ("CCPs") and trade repositories would be "encouraged" to meet or exceed such standards. The Appendix to the proposed PSR Policy would incorporate the headline text of each PFMI verbatim with no modification and without the key considerations or explanatory notes of the PFMI, although the PSR Policy Release states that the FRB "anticipates that it will be guided by the key considerations and explanatory notes of the PFMI."[2]

DTCC Comments

DTCC broadly supports the proposed revisions to the PSR Policy and the amendments to Regulation HH and believes that basing these new risk-management standards on the PFMIs is critically important to harmonizing international standards for systemically important payment systems, central securities depositories, securities settlement systems, CCPs and trade repositories. However, we believe there are certain aspects of both proposals that would benefit from clarification, and other areas–particularly where the proposed language of Regulation HH takes a more prescriptive approach than the PFMI–where we believe the FRB's position may present market challenges to FMUs and their participants and potential inconsistency between regulatory interpretations. DTCC respectfully submits the following comments on the proposals.

Liquidity – Composition of "Liquid Resources"

PFMI 7 requires an FMI to hold sufficient liquid resources to effect same-day (and, where appropriate, intraday and multiday) settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.

In determining what resources may be included in calculating an FMI's liquid resources for purposes of an FMI meeting its minimum requirement, Key consideration 5 and explanatory note 3.7.10 of PFMI 7 provide that qualifying liquid resources include "highly marketable collateral held in custody and investments that are readily available and convertible into cash with prearranged and highly reliable funding arrangements, even in extreme but plausible market conditions." A plain reading of this language is that collateral or investments comprised of highly marketable instruments may be included in qualifying liquid resources, as long as the FMI has established highly reliable arrangements for liquefying these assets, but such arrangements need not be provided on a "committed" basis.

The proposed amendments to Regulation HH provide, however, that qualifying liquid resources must consist of cash or "assets that are readily available and convertible into cash, ***through committed arrangements without material adverse change conditions***."[3] In the Regulation HH Release, the FRB acknowledged that this requirement is stricter than the requirement in PFMI 7,

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[2] PSR Policy Release, 79 Fed. Reg. 2838, 2841 (proposed Jan. 16, 2014).

[3] Regulation HH Release, 79 Fed. Reg. 3666, 3677 (to be codified at 12 C.F.R. pt. 234) (proposed Jan. 22, 2014) (emphasis added).

stating that the proposal "requires these arrangements to be committed in order to ensure that the resources are highly reliable even in extreme but plausible market conditions."[4] DTCC believes that, were this view to be applied to the CCP FMUs (particularly those operating in the cash markets where liquidity needs encompass full settlement value, as opposed to just mark-to-market changes, over the settlement period), it would present them and their market participants with a material challenge.

DTCC believes that certain highly liquid instruments, particularly U.S. Treasury securities, should be considered qualifying liquid resources, without the need for an FMI to have in place "committed arrangements" to convert such securities into cash. The U.S. Treasury market is the world's global standard for reliable liquidity, the market to which everyone turns in situations of extreme stress, and same-day settlement of U.S. Treasury securities is reliably available in material sizes. In addition, due to their robust liquidity and eligibility to be pledged at the Federal Reserve Bank discount window, U.S. Treasury securities are extremely safe for banks to accept under uncommitted repurchase agreements. Accordingly, highly reliable arrangements for these assets that would be effective even in extreme but plausible market conditions should include customary repurchase arrangements or pre-established dealer accounts to facilitate same day market sales.

In this regard, DTCC concurs with the comments recently made by the CME Group in response to a proposed rule regarding liquidity proposed by the Commodity Futures Trading Commission ("CFTC").[5] In their letter, the CME surveyed liquidity requirements, and noted that permitting U.S. Treasury securities to be considered qualifying liquid resources without the need to have in place committed arrangements to convert such securities into cash would be consistent with the treatment of sovereign debt securities by certain other jurisdictions outside of the United States in their regulations implementing the PFMIs.[6] Moreover, CME noted that, contrary to the stated intention of better protecting the FMU, requiring arrangements for liquefying such assets to be made on a committed basis could have a significant *negative* impact on the total amount of liquidity available to the Derivatives Clearing Organization FMU.[7]

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[4] *Id.* at 3677 & n.30.

[5] Letter from Kim Taylor, President, CME Clearing, to Ms. Melissa Jurgens, Secretary, CFTC, dated Sept. 16, 2013, in response to Derivatives Clearing Organizations and International Standards, RIN No. 3038–AE06, 78 Fed. Reg. 50260 (to be codified at 17 C.F.R. pt. 39) (proposed Aug. 16, 2013) ("CME Letter"), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59342 (last visited Mar. 29, 2014).

[6] CME Letter at 5-7 n.21-26 (citing, in Australia: Res. Bank Austl., *Guidance — Financial Stability Standards for Central Counterparties*, ¶¶ 7.4, 7.4.1, 7.4.2 (Dec. 2012); in the European Union: European Market Infrastructure Regulation Regulatory Technical Standards (EMIR RTS), Commission Delegated Regulation (EU) No. 153/2013, art. 33(1)(e); European Market Infrastructure Regulation, Regulation (EU) No. 648/2012, arts. 45-46; in Singapore: Singapore Exch. Derivatives Clearing Ltd. (SGX-DC), *Making SGX Derivatives Clearing Transparent for Market Participants: Disclosure Document for SGX Derivatives Clearing's Services*, at 55-56 (Jul. 9, 2013)).

[7] CME Letter at 9-12. Among the "negative externalities" associated with such requirements, CME cites: (a) impact under Basel III capital rules, e.g., (i) more cash and less U.S. Treasury securities would be required to be pledged, resulting in a higher capital charge to pledging banks due to unconfirmed bankruptcy remoteness of cash versus U.S. Treasury securities, (ii) banks would be penalized for providing committed facilities to monetize U.S. Treasury securities under their leverage ratio and liquidity coverage ratio, as well as for their exposure measure for off-balance-sheet items, and (iii) banks that are members of the FMI and also participate in a committed facility with the FMI to monetize U.S. Treasury securities might risk exceeding their single-party exposure limit; and (b) the commercial availability of committed liquidity facilities.

Moreover, U.S. banking regulators recently promulgated a proposed minimum liquidity requirement for large institutions.[8] Under that proposal, there is no requirement that U.S. Treasury securities be held under committed arrangements for such securities to be considered "high quality liquid assets." The FRB has not provided any substantive explanation for treating FMIs and their liquidity needs differently from the liquidity needs of SIFIs.

Finally, neither the CFTC's final rule for derivatives clearing organizations[9] nor the SEC's recently proposed rules for covered clearing agencies[10] require U.S. Treasury securities to be held under committed arrangements in order for them to be considered qualifying liquid resources.

General Business Risk – Components of Required "Equity"

Proposed § 234.3(a)(15) of Regulation HH requires a designated FMU for which the FRB is the Supervisory Agency to maintain, at a minimum, sufficient liquid net assets funded by equity to cover the greater of (1) the cost to implement its recovery or orderly wind-down plan to address general business losses and (2) six months of current operating expenses. DTCC is generally supportive of this proposal, and recognizes the importance of both the quantity and quality of an FMI's capital base to ensure sufficient loss absorbency resulting from business losses. However, we believe the proposal, as well as the PSR Policy, should be clarified to make clear that some portion of equity in the form of noncumulative perpetual preferred stock may be included in calculating the amount of an FMI's funded equity.

The Regulation HH provision provides, in relevant part, that:

> in addition to holding financial resources required to manage credit risk . . . and liquidity risk . . . the designated financial market utility . . .
>
> (B) ***Holds equity, such as common stock,*** disclosed reserves, and other retained earnings, that is at all times greater than or equal to the amount of unencumbered liquid financial assets that are required to be held under paragraph (A) of this section (emphasis added);

This language is consistent with key consideration 2 and explanatory note 3.15.5 of PFMI 15, which provide, in relevant part:

> An FMI should hold liquid net assets funded by equity (***such as common stock***, disclosed reserves, or other retained earnings) so that it can continue operations and services as a going concern if it incurs general business losses. (emphasis added)

DTCC believes that the highlighted clause "*such as common stock*" is meant to be illustrative and not prescriptive or limiting. DTCC recommends that what constitutes equity capital should

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[8] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71818 (to be codified at 12 C.F.R. pts. 50, 249, 329) (proposed Nov. 29, 2013).
[9] 17 C.F.R. § 39.33, 78 Fed. Reg. 72476 (Dec. 2, 2013).
[10] Standards for Covered Clearing Agencies, 79 Fed. Reg. 16866 (to be codified at 12 C.F.R. pt. 240) (proposed Mar. 26, 2014).

be clarified and broadly construed in both the PSR Policy and Regulation HH to include noncumulative perpetual preferred stock, which would be "permanently available," as provided in explanatory note 3.15.5. These securities provide for loss absorption for the purposes of Principle 15, without posing added risks. Such a broad definition of equity capital is necessary and important to provide a range of capital support and replenishment options to FMIs, particularly industry-owned utilities that do not have ready access to public capital markets to replenish capital.

The FRB has acknowledged in the Regulation HH Release that flexibility is needed, particularly with respect to designated FMUs that are already subject to other regulatory capital standards. The Regulation HH Release provides, in relevant part:

> For cases in which a designated FMU is subject to international risk-based capital standards or other relevant [FRB]-imposed capital requirements, the [FRB], at its discretion, may allow a designated FMU to use the equity held for this purpose towards the designated FMU's equity requirement in proposed § 234.3(a)(15)(i)(B) to avoid duplicate capital requirements.[11]

Under the U.S. banking regulators' final regulations implementing the Basel III regulatory capital requirements, most bank-issued noncumulative perpetual preferred stock would constitute "additional tier 1 capital."[12] Accordingly, DTCC believes that the elements of capital that constitute (or would constitute, if the FMI were subject to Basel III capital requirements) "common equity tier 1 capital" or "additional tier 1 capital" under Basel III should be permitted to count as equity for purposes of PFMI 15, and the flexibility reflected in the Regulation HH Release should be reflected in the final texts for both Regulation HH and the PSR Policy.

Segregation and Portability

PFMI 14 provides that a CCP should have rules and procedures that enable the segregation and portability of positions of a participant's customers and the collateral provided to the CCP with respect to those positions. The explanatory notes and footnotes thereto confirm that, in certain jurisdictions, *cash market CCPs* operate in legal regimes that facilitate segregation and portability to achieve protection of customer assets by alternate means that offer the same degree of protection as the approach required by PFMI 14.[13]

In the Regulation HH Release, the FRB acknowledged that cash market CCPs operate within a different legal framework that offers the same degree of protection for a participant's

[11] 79 Fed. Reg. at 3682; *see also* PFMI 15, explanatory note 3.15.7 ("However, equity held under international risk-based capital standards should be included where relevant and appropriate to avoid duplicate capital requirements.").
[12] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital, 78 Fed. Reg. 62018, 62172-73 (to be codified at 12 C.F.R. §§ 3.20(c), 217.20(c)) (Oct. 11, 2013); *see also id.* at 62048 ("The agencies expect that most outstanding noncumulative perpetual preferred stock that qualifies as tier 1 capital under the agencies' general risk-based capital rules will qualify as additional tier 1 capital under the final rule.").
[13] PFMI 14, explanatory notes 3.14.5, 3.14.6 & n.122.

customers as the approach required by proposed § 234.3(a)(14).[14] In the PSR Release, the FRB acknowledged structural differences among FMIs only more generally.[15] While the language in the Regulation HH Release (and the more general language of the PSR Policy Release) provides helpful legislative history as to how the provisions are intended to be interpreted, DTCC believes that the final text of both regulations requires this clarification, without which the stated regulation (or policy) has no clear context to permit (or imply) a different cash market approach. Accordingly, with respect to segregation, DTCC requests that the final text of the PSR Policy and Regulation HH acknowledge the different legal frameworks for cash markets (whether by footnote or otherwise).[16]

Effective Compliance

DTCC believes that the FRB should acknowledge in the final PSR Policy that if a regulatory agency other than the FRB is the Supervisory Agency of a designated FMU, then the FRB would consider compliance by the FMU with the corresponding PFMI-based regulations of such Supervisory Agency to satisfy the FMU's obligations under the PSR Policy. The same approach should also apply to other FMIs, such as trade repositories, that comply with their primary regulator's PFMI-based regulations. While DTCC believes that statements made by the FRB in the PSR Policy Release generally acknowledge this view,[17] DTCC requests that the FRB expressly acknowledge this in adopting the PSR Policy in final form. This is important to provide the necessary clarity as to regulatory expectations, and avoid overlapping and potentially conflicting application of PFMI-based regulations.[18]

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[14] 79 Fed. Reg. at 3681 ("Effective segregation and portability not only depends on the operational capabilities of the designated FMU, but also on the applicable legal framework. A cash-market central counterparty, for example, may operate in a legal regime that offers the same degree of protection for a participant's customers as the segregation and portability approaches under proposed § 234.3(a)(14). In such cases, the [FRB] will take into consideration a central counterparty's assessment of whether the applicable legal or regulatory framework achieves the same degree of protection and efficiency for customers that would otherwise be achieved by segregation and portability arrangements at the central counterparty level described in the proposed standard. The [FRB] believes segregation and portability arrangements may differ depending on the design of a central counterparty and would work with any applicable designated FMU through the supervisory process to determine how best to set specific requirements.").

[15] *See* PSR Policy Release, 79 Fed. Reg. at 2848 ("The Board acknowledges that FMIs vary in terms of the scope of instruments they settle and markets they serve. It also recognizes that FMIs may operate under different legal and regulatory constraints, charters, and corporate structures. The Board will consider these factors when reviewing the disclosures and in evaluating how an FMI addresses a particular standard.").

[16] This is particularly important where other jurisdictions will look to implemented regulation to determine regulatory equivalence.

[17] *See* PSR Policy Release, 79 Fed. Reg. at 2839 ("In setting out its views, the [FRB] seeks to encourage these systems and their primary regulators to take the standards in this policy into consideration in the design, operation, monitoring, and assessment of these systems."); s*ee also id.* at 2848 ("It also recognizes that FMIs may operate under different legal and regulatory constraints, charters, and corporate structures. The [FRB] will consider these factors when reviewing the disclosures and in evaluating how an FMI addresses a particular standard. Where the [FRB] does not have statutory or exclusive authority over an FMI, it will be guided by this policy in cooperative efforts with other domestic or foreign authorities to promote comprehensive disclosures by FMIs as a means to achieve greater safety and efficiency in the financial system.").

[18] For example, where the relevant Supervisory Agency permits the designated FMU to include U.S. Treasury or other highly liquid securities as qualifying liquid resources provided they are held subject to highly reliable arrangements to liquefy such assets even in times of market stress, then the FRB should, in assessing the designated FMU's compliance with the PSR Policy, consider the designated FMU to be compliant with Principle 7 of the

Implementation Timeframe

The FRB has proposed that the PSR Policy will become effective when the final version is published in the Federal Register, but recognizes that several of the expectations in the revised policy are new or heightened and, therefore, FMIs may need more time (up to 6 months) to implement such expectations. Among the questions for which the FRB has requested specific feedback is whether 6 months is enough time to enable the new expectations to be implemented.[19] DTCC notes that when evaluating the sufficiency of this timeframe, the FRB should be aware that, to the extent that an FMI is required to engage in a rulemaking or advance notice process (or other analogous process to which an FMI may be subject) in order to implement or comply with the new expectations to which it will become subject, that process would provide an opportunity for public comment and regulatory approval, with the result that the FMI may not be able to effectively control the timing of such approvals, and they may extend beyond a 6-month period.

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DTCC appreciates the opportunity to comment on the proposed revisions to the PSR Policy and the proposed amendments to Regulation HH. Should you wish to discuss these comments further, please contact me at 212-855-3240 or lthompson@dtcc.com.

Sincerely yours,

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PSR Policy if the designated FMU is compliant with its Supervisory Agency's corresponding implementing regulations.

[19] Among the new expectations that the FRB recognizes may take additional time to implement are the revised expectations on transparency, the expectation to manage risks arising in tiered participation arrangements under Principle 19, certain aspects of Principle 3 (Framework for the Comprehensive Management of Risks), Principle 4 (Credit Risk), Principle 7 (Liquidity Risk) and Principle 15 (General Business Risk).